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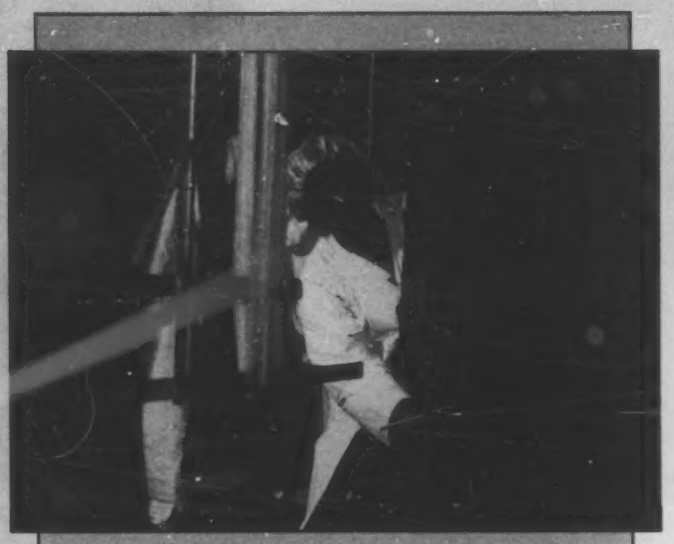
June 27, 1988

# Investment Age



Eagle-Picher Industries, manufacturer of industrial products, saves as much as 150 basis points annually through passive management.

## Passive funds lift returns for 3 corporations

By Barry B. Burr

Three corporate pension funds with all or most of their assets under passive management during the bull market plan to continue to index, even though the median active equity manager beat the Standard & Poor's 500 index for the 12 months ended March 31.

Polaroid Corp., Cambridge, Mass., has indexed the entire equity portion of its $576 million pension fund since 1981, while running all of its fixed income actively.

Eagle-Picher Industries Inc., Cincinnati, has had all of its $140 million fund — equities and fixed income — under passive management since 1981.

The $107 million pension fund of Turner Corp., New York, has indexed all its equities

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## DOL to probe 23 on proxies

By Marcia Parker

Gillette Co., Allied-Signal Inc. and Texaco Inc. are targets of the Department of Labor's proxy monitoring "hit list."

*Pensions & Investment Age* also has learned the chairmen of Gillette and Allied-Signal made written appeals to fellow chief executives requesting they talk to their pension fund managers about voting proxies in support of those companies' managements.

The Labor Department earlier this month requested proxy voting records from fiduciaries of several companies as part of its stepped-up proxy monitoring program (*P&I Age*, June 13). At the time, only Gillette, which recently won a hard-fought proxy contest between management and The Coniston Group for company control, was known to be on the list of 23 names.

The Labor Department is seeking to ensure proxy voting practices are well-planned and well-documented, and no improper pressure is being applied to those who hold proxy voting authority.

According to a full list of target companies obtained since by *P&I Age*, the others are: Santa Fe Southern Pacific Corp.; USAir Group Inc.; Media General Inc.; Coleman Co. Inc.; International Paper Co.; Kerr-McGee Corp.; Martin Marietta Corp.; Pitney Bowes Inc.; United Technologies Corp.; Champion International Corp.; Upjohn Co.; Boise Cascade Corp.; Tenneco Inc.; Champion Spark Plug Co.; Honeywell Inc.; Lockheed Co.; Unocal Corp.; Amoco Corp.; Chevron Corp.; and Mobil Corp.

The Labor Department's target companies include some of the most hotly contested proxy battles of the 1988 season as well as others involving corporate campaigns to defeat shareholder-sponsored corporate governance resolutions.

The letters sent by Gillette and Allied-Signal executives are a twist on a letter-writing campaign launched during last year's proxy season. A controversy erupted when several chief executives wrote their counterparts asking them to use their influence with pension fund managers to support management's positions on shareholder resolutions, especially withdrawals of poison pills (*P&I Age*, April 6, 1987).

The 1987 letter-writing campaign is believed to be the catalyst of the Labor Department's 1988 proxy monitoring initiative, its widely circulated warning letter to Avon Corp. on proxy voting, and the guidelines for pension plan fiduciaries it issued this year.

Pension fund executives, money managers and institutional investors said they would be watching to see how the department views the latest letters and the aggressive campaigns launched this year to defeat raiders who waged proxy battles and corporate governance shareholder resolutions.

The Labor Department is not believed to view

*Continued on page 35*

## Social issues abate

### Resolutions find only limited support

By Trudy Ring

The 1988 proxy voting season was less than stellar for shareholder resolutions dealing with social issues, but sponsors still saw a few bright spots.

Average support for shareholder resolutions seeking corporate withdrawal from South Africa fell somewhat, but for the first time there was significant support for resolutions that called for ending non-equity ties, such as licensing agreements, in that nation.

A record number of companies faced resolutions on their operations in Northern Ireland, but support for such resolutions dropped at most companies where the issue had been raised previously. Support rose on average, however, in part because of one large vote.

In all, 87 resolutions on South Africa came to votes. Twenty asked companies only to withdraw their operations from that nation; 33 asked them to withdraw and sever other ties; 15 asked companies without direct investment to cut non-equity ties; and the remainder addressed such issues as endorsement of the Statement of Principles (formerly the Sullivan Principles) and sales to the South African government, police and military.

**10 largest vote-getters among South Africa withdrawal resolutions**

| Company | Shares voted in favor |
|---|---|
| Gillette [1] | 21.9% |
| Gillette [2] | 21.4 |
| Colgate-Palmolive | 17 |
| Goodyear | 16.1 |
| MCA | 15.6 |
| NCR | 15 |
| Baker Hughes | 14.8 |
| Tenneco | 14.5 |
| Squibb | 14.2 |
| Caterpillar | 14.2 |

[1] Withdrawal only
[2] Withdrawal and cut all other ties
Source: Investor Responsibility Research Center

South Africa withdrawal resolutions won support from 20% or more of the shares voted at only one company, Gillette Co., compared with five companies in 1987. (All IRRC vote data excludes abstentions.)

Support for New York-based Coniston Group's nearly successful bid to take over Gillette apparently spilled over to other dissident shareholder resolutions, said Carolyn Mathiasen, director of the social issues service at the Investor Responsibility Research Center, Washington.

The New York State &

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INSIDE

## PROPERTY in this issue

Making money with company-owned land is Delmarva Power & Light Co.'s corporate real estate philosophy, and that's just what the utility did with this data center. Details on Delmarva's strategy — along with stories on mortgage lenders scrambling for business and the world's largest real estate billboard — are in PROPERTY, a quarterly supplement on real estate finance and investing. Pages P1-P16.

## LATE NEWS

### Moratorium gaining momentum

WASHINGTON — A bill that would place a moratorium on employers using the surplus assets of terminated pension plans unexpectedly picked up speed last week when it was attached to an appropriations bill.

Amid objections by leaders of the Senate Finance Committee as well as the administration, the Senate Appropriations Committee voted to keep the proposal in the bill, which contains appropriations for the departments of Labor, Health and Human Services, and Education.

The bill will be considered on the Senate floor this week.

### Merger of 2 Russell units seen

TACOMA, Wash. — The Frank Russell Trust Co. and the Frank Russell Investment Co. reportedly will be combined under the command of Lynn Anderson, president and chief executive officer of the investment company.

Frank Russell Investment was launched in August 1981 as a mutual fund offering a series of commingled funds. Shares of the fund are only open to bank trust departments and tax-exempt funds that enter into an asset management agreement with Frank Russell Co., which is the manager of managers for the funds.

Frank Russell Trust Co. is also a manager of managers offering 10 pooled funds as well as separate accounts. The company is headed by Paul Kaltinick, president and chief executive officer.

The Frank Russell Co. declined to comment because the changes haven't been finalized.

### LaSalle seeks partner for capital

CHICAGO — LaSalle Partners Inc., Chicago, is looking for a minority partner, and among the candidates mentioned by sources are Dai-Ichi Mutual Life, Japan's second largest insurance company, and San Francisco-based Transamerica Corp.

William Sanders, chairman and chief executive officer of LaSalle, issued a statement saying "LaSalle Partners has been in discussion with several corporate and institutional organizations — both domestic and foreign — regarding a minority limited partnership investment in its firm."

Sources said Dai-Ichi and Transamerica are among those that have held discussions with LaSalle officials. Dai-Ichi, however, is considered the more likely candidate because Transamerica "wanted a little more involvement" in the firm than LaSalle executives were willing to permit, according to one source.

Some sources had said Dai-Ichi would pay up to $150 million for a 40% stake in LaSalle Partners and would provide its pension advisory division with another $1 billion in assets to manage. Mr. Sanders called those figures "totally inaccurate."

### Sponsors, advisers change jobs

Several pension industry executives have announced job changes recently.

• Charles P. Dunn, director-pension finance and investments at North American Philips Corp., New York, will join Reich & Tang L.P. July 11 as a vice president responsible for client servicing, marketing and development of new products.

He is replacing Gene Hoots, the former president of RJR Investment Management Inc. (now part of RJR Nabisco Inc., Atlanta). Mr. Hoots is joining Watnik and Son, a Springfield, N.J.-based pension consulting group.

• James Penner was expected to be named investment officer of the Montana Board of Investments, Helena, last week, replacing James Howeth, who is resigning effective June 30.

David Lewis, executive director of the board, which oversees nine state retirement plans with more than $2.6 billion in assets, said the expected appointment would be for a "probationary" period of three to six months, after which he expects Mr. Penner to be given the job permanently.

Mr. Howeth has formed his own investment firm, The Anna Corp., in Helena.

• In San Francisco, two Hambrecht & Quist Equity Management executives — Bill Welty, director of research, and Pat McBaine, executive vice president and head of institutional sales — are leaving the firm this summer to start separate investment management companies.

Mr. Welty will be succeeded by Barney Hallingby, now in institutional sales in the company's New York office; Mr. McBaine's successor hasn't been named.

• James E. Heard, who joined T. Boone Pickens' shareholder rights group United Shareholder Association six months ago as executive director, left to join Analysis Group Inc., to advise institutional investors on proxy voting issues.

Mr. Heard and a spokesman for USA said Mr. Heard's interests and the group's needs did not mesh and they reached a mutual decision to part ways.

Before joining the USA, Mr. Heard was deputy director of the Investor Responsibility Research Center in Washington, where he had worked for about nine years.

## DEPARTMENTS


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# Funds gird for tax

## Australian plans move to domestic stock

SYDNEY, Australia — The Australian government's almost-certain imposition of taxes on domestic pension funds has caused a rush into domestic equities, and might augur significant shifts in funds' investment strategy.

The changes, proposed in the government's May 25 minibudget, already have generated a move into high-yield stocks, although some observers think that might have been premature. But pension experts believe the tax changes might lead to increased use of passive investment vehicles and decreased investments in bonds. And views differ on whether funds will cut overseas equities.

For all investors, the outlook for the previously lagging Australian stock market has brightened, as lower corporate taxes and higher inflation prospects have given it a boost.

The taxation of previously tax-exempt Australian funds has global significance, as many governments, including the United States, have looked to pension funds as a source of revenue. Last year, New Zealand imposed similar taxes on its pension funds.

The changes in the Australian system are expected to generate $770 million in new revenue as part of an expected $2.36 billion budget surplus. (All amounts reflect U.S. dollars.)

The growing Australian pension market has about $66 billion in assets.

The changes affecting Australian pension funds — known as superannuation funds here — take effect July 1, although industry is lobbying for postponement of some of the effective dates.

The new rules would impose a 15% tax on:

• investment income, including rents, dividends and interest;

• realized capital gains (measured as those exceeding the inflation rate — if the security is held for at least one year) in the year in which the asset is sold; and

• deductible employer contributions.

Pension funds, however, might be able to completely offset any taxes. Under the rules, funds will get a 39% tax credit on fully franked dividends — dividends from profits on which corporate tax has been paid. But the "imputation credit" cannot be used to offset taxes withheld by other countries on foreign stocks, thus lessening the allure of foreign markets.

But the availability of capital gains tax rates will make all equities — domestic and foreign — more attractive than bonds, making the impact on foreign stocks a wash, said Craig Ueland, managing director of Frank Russell Australia, Sydney.

The Australian stock market, which had lagged other world markets in recovering from last October, surged after the minibudget was announced. Although still far below its pre-crash 2,300 level, the All Ordinaries index climbed to 1600 in mid-June from 1470 May 25.

*Continued on page 37*

# Hedged indexes mulled

By Marlene Givant

Currency and asset allocation experts are urging pension fund executives to adopt fully hedged international portfolios and benchmarks — moves that could transform the investment management and risk/return profile of overseas investments.

The use of hedged benchmarks could revolutionize the way plan executives look at international investments as an asset class, causing the executives to focus just on underlying security returns, and separating the currency factor. An increased demand for hedging and adoption of hedged benchmarks also could force managers to build their hedging capabilities.

Only a few funds are starting to experiment with hedged benchmarks, but many are looking at the idea. The $3.5 billion endowment of The Common Fund, Fairfield, Conn., which has $1 billion in international equities and global bonds, sometimes uses a hedged benchmark, the Salomon Brothers Hedged World Government Bond index, to measure the volatility of global bond accounts.

Its primary global bond benchmark, however, is the Shearson Lehman Hutton Government/Corporate bond index, said Curt R. Tobey, vice president.

Many funds are considering adopting a full- or partial-hedge policy.

"Hedging is an issue we're actively looking at these days. We sort of believe the dollar is in a narrow trading range, but we're more serious (about hedging) now than a year ago," said Charles C. Weaver, director-pension funds of the $6 billion Southwestern Bell Corp. pension fund, St. Louis, which has 5% in international equities.

Most pension executives leave hedging decisions to their managers, who generally hedge into the U.S. dollar when they want protection from a rise in the currency. But the practitioners think funds should hedge not only when managers are bullish on the dollar but also when they are neutral.

Funds should only lift the dollar hedge when they expect to gain by doing so, the practitioners say.

Currency gains have accounted for much of the returns from international investing during the past few years, and some pension fund executives are looking to hedge because the party might be over.

Some observers fear increased demand for hedging and the use of hedged benchmarks by pension funds could force managers to hedge more than they otherwise would.

"There are strong academic arguments for being fully hedged as a normal position. My concern is

*Continued on page 37*

# Bank in record-keeping

NEW YORK — Manufacturers Hanover Trust Co. has been active in employee benefit participant record-keeping since 1984 and remains committed to that area for both defined benefit and defined contribution plans, according to Renee San Marco, vice president.

Manufacturers Hanover was listed incorrectly in a June 13 article as being among eight major banks to withdraw from participant record-keeping in the past two years.

"We feel our system can handle most employee benefit plans in existence today with no problems," said Eugene Bacich, vice president in charge of the bank's participant record-keeping department.

"The bank has made a major commitment to master trust and employee benefit trust services and record-keeping is part of that commitment for both defined benefit and defined contribution trusts."

Mr. Bacich said the bank plans to enhance its participant record-keeping system soon to handle daily valuations for unit accounts or company share accounts.

He said the Manufacturers Hanover system is flexible enough to support multiple vesting schedules or an individual vesting schedule for each fund included in a plan. In addition, the system can handle any combination of 99 investments and funding sources. ■

**Top index fund managers ($ millions - as of May 31)**

| | Total indexed | Domestic equity | Domestic fixed | International |
|---|---|---|---|---|
| Wells Fargo Investment[1] | 47,350 | 34,500 | 11,050 | 1,800 |
| Bankers Trust[2] | 21,291 | 18,547 | 2,494 | 250 |
| Mellon Capital Mgmt. | 20,000 | 17,000 | 2,700 | 300 |
| State Street Bank | 16,584 | 10,050 | 2,203 | 4,331 |
| America Nat'l Bank / Chicago[3] | 9,550 | 8,250 | 1,200 | 100 |
| Mitchell Hutchins | 6,750 | 250 | 6,500 | 0 |
| Mellon Bond | 5,800 | 0 | 5,800 | 0 |
| Alliance Capital Mgmt. | 5,540 | 4,800 | 240 | 500 |
| Dimensional Fund Advisors[4] | 5,000 | 3,500 | 1,100 | 400 |
| Boston Co. | 4,818 | 3,457 | 1,192 | 169 |
| GE Investment Advisors | 3,800 | 3,800 | 0 | 0 |
| Manufacturers Nat'l/Detroit | 3,123 | 3,100 | 23 | 0 |
| Wilshire Asset Mgmt. | 2,850 | 2,850 | 0 | 0 |
| Chase Investors Mgmt. | 2,393 | 1,350 | 343 | 700 |
| Lehman Mgmt. | 2,390 | 0 | 2,390 | 0 |
| Lincoln Capital | 2,266 | 0 | 2,266 | 0 |
| T. Rowe Price | 2,125 | 200 | 1,925 | 0 |
| Putnam Cos. | 1,579 | 0 | 1,579 | 0 |
| Northern Trust[5] | 1,357 | 894 | 142 | 17 |
| Prudential Asset Mgmt.[4] | 1,232 | 598 | 365 | 269 |
| Sears Investment | 1,260 | 1,260 | 0 | 0 |
| WR Lazard | 906 | 0 | 906 | 0 |
| BEA Associates | 886 | 580 | 306 | 0 |
| Vanguard Group | 811 | 788 | 23 | 0 |
| Security Capital Mgmt. | 779 | 0 | 779 | 0 |
| Citicorp | 704 | 704 | 0 | 0 |
| Capstone | 670 | 370 | 300 | 0 |
| MacKay-Shields Financial | 570 | 0 | 570 | 0 |
| Bernstein-Macaulay | 560 | 560 | 0 | 0 |
| Harris Trust | 488 | 288 | 200 | 0 |
| Axe Core Investors | 469 | 249 | 0 | 220 |
| FirstRepublic Bank | 464 | 414 | 50 | 0 |
| ASB Capital Mgmt.[4] | 430 | 430 | 0 | 0 |
| Centerre Trust | 385 | 385 | 0 | 0 |
| Travelers | 338 | 232 | 24 | 82 |
| Aetna Life | 310 | 240 | 70 | 0 |
| First Wisconsin Trust[4] | 305 | 80 | 225 | 0 |
| Fiduciary Trust | 300 | 0 | 300 | 0 |
| Old Kent Bank & Trust | 300 | 300 | 0 | 0 |
| Associated Capital Investors | 224 | 155 | 69 | 0 |
| Metropolitan Life | 222 | 222 | 0 | 0 |
| Todd Investments | 213 | 0 | 213 | 0 |
| Bear Stearns Asset Mgmt. | 190 | 0 | 190 | 0 |
| Nat'l Bank of Detroit | 160 | 160 | 0 | 0 |
| Kiene, Wooters & Associates | 150 | 100 | 50 | 0 |
| Advanced Investment Mgmt. | 103 | 93 | 10 | 0 |
| Chemical Investment Group | 103 | 0 | 103 | 0 |
| Westridge Capital | 100 | 100 | 0 | 0 |
| Western Asset | 82 | 0 | 82 | 0 |

[1] as of 4/30
[2] as of 1/1
[3] as of 3/1/87
[4] as of 3/31
[5] total includes $904 million in balanced indexed funds

# International spurs indexing

**By Curtis Vosti**

International index fund assets managed by 13 leading international indexers grew nearly 57%, to more than $9 billion, since Nov. 30, a *Pensions & Investment Age* survey shows.

Adjusted for market valuations — for the six months ended May 31, the Morgan Stanley Capital International Europe Australia Far East index returned 16.7% — international indexing still grew 40.4%.

The growth in international indexed assets, however, was not enough to offset sluggish growth in the domestic equity and fixed-income indexed arena, where the growth in total assets did not match the expected growth from market appreciation.

All told, 49 top index managers surveyed recently report indexing $178.3 billion in domestic and international accounts for tax-exempt clients.

Of the 36 managers surveyed both for May 31 and Nov. 30 figures, the total amount indexed increased to $168.52 billion from about $157.01 billion — an increase of only 7.3%.

The Nov. 30 figures in each of the three categories, adjusted for market appreciation, would have been expected to grow to $176.61 billion.

After adjusting the Nov. 30 figures for market growth, domestic equity indexing was down $11.1 billion, while domestic fixed-income indexing was up slightly.

Domestic equity index investments totaled $120.9 billion May 31 among the 49 index fund managers; domestic fixed-income index funds accounted for $47.5 billion.

On Nov. 30, 37 money managers cited $107.5 billion in domestic equity index funds and $43.7 billion in domestic fixed-income funds.

Of the 36 firms common to both surveys, domestic equity indexing increased to $113.39 billion from $107.45 billion, an increase of 5.5%.

For the six months ended May 31, the Standard & Poor's 500 stock index advanced 15.8%.

Among the 36 managers common to both surveys, the amount invested in domestic fixed-income indexed accounts rose to $45.99 billion from $43.74 billion, an increase of 5.1%.

For the six-month period ended May 31, the Shearson Lehman Hutton Government/Corporate bond index returned 3.7%.

Indexed accounts run in-house by 15 of the top 200 pension funds dropped $4.8 billion to $21.8 billion May 31, from $26.6 billion as of Jan. 1.

Those 15 sponsors reported $19.4 billion in domestic equity indexed accounts, with the remaining $2.3 billion in domestic fixed-income indexed accounts.

The assets of the 13 money managers that run international indexed accounts grew to $9.1 billion from $5.8 billion as of Nov. 30.

State Street Bank and Trust Co., Boston, reported the biggest gain in international indexed assets, $1.14 billion since Nov. 30, for a total of $4.33 billion.

Wells Fargo reported a $1.039 billion gain — to $1.8 billion — in assets indexed internationally.

"There's been a tremendous growth in international investing in general," said Peter Braun, vice president/director of marketing for State Street's asset management division. Large public pension funds, "think perhaps the best way to establish a core international portfolio is through an index process," he said.

Other factors he lists as favoring international indexing are the "pretty overwhelming" underperformance the last five years of active international managers when compared with the EAFE index and the relatively high costs of active international management.

While international indexing booms, the virtual stagnation of domestic indexing is due in part to the "maturing" of that industry, according to David Hurley, vice president for Investment Index Technologies Inc., Newark, N.J., a subsidiary of Prudential Asset Management, Newark, N.J. Prudential manages $1.2 billion in tax-exempt accounts spread between domestic equity and fixed

*Continued on page 38*

# Favia Hill shut down

## Chemical moves to stem more losses

**By Joel Chernoff**

NEW YORK — Chemical Bank's dismantling of its ill-fated Favia, Hill & Associates Inc. subsidiary is viewed as the final chapter in the firm's troubled five-year life span.

For now, the move is seen as a way to help Chemical staunch further losses of the unit's remaining equity business. Favia, Hill has $1.2 billion in equity assets, down substantially from its peak of $3.2 billion at year-end 1983.

It is an attempt to "salvage what they could on the equity side and not disappear into the night," said Eric Weissenberger, formerly a marketer for Favia, Hill and now director of marketing and client services for Home Capital Services Inc., New York.

"It's probably a good idea for them to consolidate the business," echoed Joseph Scarella, a consultant at Wyatt Asset Services, New York.

Clients have the choice of having their equity accounts transferred to one of three other Chemical equity management units: Texas Commerce Investment Management Co., Houston; Quantum Investment Management Inc., New York; or Investment and Capital Management Corp., Rolling Meadows, Ill.

Clients whose accounts had been run by Kenneth Rolland, chief investment officer of the disbanded unit, may retain him. Mr. Rolland is a managing director of Chemical Investment Group, which is the holding company structure for five of Chemical's investment management firms.

Outsiders, however, expect Chemical might lose many of its remaining equity accounts.

Favia's $3.8 billion in fixed-income assets and cash have been merged with the bank's Treasury Asset Management unit into a new subsidiary, Chemical Investment Management.

Chemical's Edward Madden said the bank is maintaining its commitment to equities.

Continuing to oversee the bond accounts in the new unit is William Budd, managing director-fixed-income management. Alexander Laird, recently hired from Hutton Asset Management, will continue to have responsibility for the $3 billion in cash management accounts brought from Treasury Asset Management.

Edward E. Madden, managing director for Chemical Investment Group, said the bank is maintaining its commitment to equity management and money management overall. Rumors had circulated earlier this year that Chemical might sell its money management operation, following the course of Citicorp and Manufacturers Hanover Corp.

Mr. Madden noted the bank is working on a plan to give key professionals a 19.9% stock interest in Chemical Investment Group, reflecting its commitment to money management. While the group's revenue is not disclosed, Mr. Madden said it is better this year than last year.

"There is no doubt that Chemical is committed to this business," he said. Chemical Investment Group has $13.7 billion in total assets under management.

Still, some observers believe Favia's history, including poor equity performance and turnover in key personnel, reflects the bank's sometimes half-hearted efforts to build an independent money management subsidiary.

"Chemical never jumped in and supported it," said an official at another New York money-center bank.

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Photo by Linda Sue Scott

Greta Marshall will jump into starting her own investment firm after her stint with the California Public Employees' fund ends this week.

# Marshall diving into new waters

**By Curtis Vosti**

SACRAMENTO, Calif. — Avid skyjumper Greta Marshall is ready to take the plunge into entrepreneurship when she ends her three-year association with the $45 billion California State Employees' Retirement System this week.

Ms. Marshall is planning to start her own investment firm as soon as she can get commitments from the "two or three or four" partners she wants.

"I think it's coming together eventually, perhaps in a week" she said, adding "timing" prevented her from releasing the names of those who are expected to work with her.

It's another challenge the 50-year-old sportswoman and invest-

*Continued on page 38*

PORTFOLIO MANAGEMENT

FEATURE

# Fee schedule impact

## Individuals' pay affected

By Gregory Keshishian

As the use of performance-based fees gains greater acceptance, it might complicate the incentive compensation plans used by investment management firms.

Corporate clients need to understand these compensation trends and their effect on motivating portfolio managers to achieve desired performance. Sponsors have an indirect, but still influential, impact on compensation policy when negotiating performance-based fees.

The use of such fees might force compensation designers and decision-makers to focus even more heavily on individual contribution, possibly having an adverse effect on team effort.

If firm profitability is adversely affected by the new performance-based fee structures, there simply may not be enough money available to direct incentive compensation dollars strategically around the firm. Under certain circumstances, even the top-performing portfolio manager may not be assured an adequate bonus if firm profitability is hurt.

Behaviorally, this situation might reinforce internal competitiveness rather than cooperation, and would require management leadership to overcome possible divisiveness and lack of team spirit.

Providing high-quality professional talent with strong individual motivation to outperform the competition is still the primary focus of incentive plans. The challenge will be to achieve this when overall fees are under pressure, while preserving a collegial atmosphere.

In assessing current programs, an essential task is to determine whether the system is well-aligned with a firm's overall business objectives and human resources strategies.

To make it meaningful, there should be a retrospective evaluation of the compensation system's effectiveness and a willingness to fine tune or substantially modify it.

The introduction of performance-based fees may influence the revision and redesign of these systems.

Gregory Keshishian is a senior consultant with Handy Associates, New York, a compensation consulting firm.

This evolving parallel between management fees based on performance and portfolio manager compensation for performance may dramatically change the expectations of investment professionals as to what constitutes a fair and competitive reward.

The designers of pay plans in the industry have been faced with the dilemma of rewarding individual investment performance in the context of firmwide results. This has been complicated by the desire to achieve an equitable distribution of incentive dollars based on the asset size of portfolios managed (by individual portfolio managers) and firmwide fee income derived therefrom.

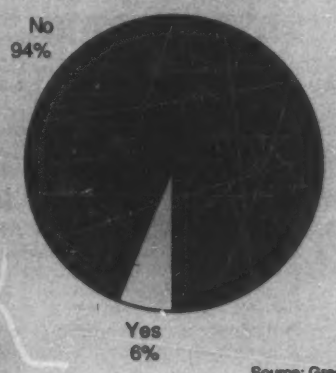
In the past, firm managements often have attempted to direct dollars to those individual portfolio managers whose personal investment performance was superior, even if overall firm performance was lackluster. Their ability to make such incentive distributions was attributable to the fact the primary determinant of firm revenue and profitability was total assets under management.

While there undoubtedly has been a cause-and-effect relationship between comparative investment performance and the movement of pension assets, the revenue stream from existing accounts continued as long as these accounts were in place. Thus, the flexibility to move compensation dollars to high individual performers was often retained, even if overall firm performance was not fully competitive in a given year.

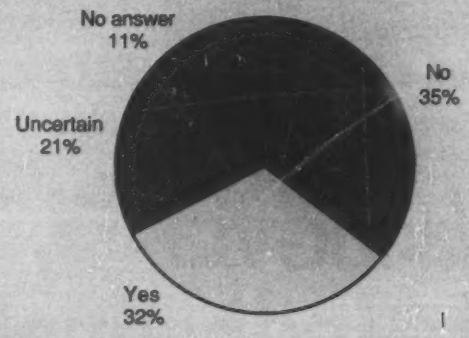
How will firms deal with the

*Continued on page 14*

**Do you have performance-based fees?**




**Do you favor regulation allowing performance-based fees?**




Source: Greenwich Associates, Greenwich, Conn.

# Crash puts drag on searches

CHICAGO — Money management searches are down 30% since the October crash, according to one major consultant's engagement activity.

Searches the firm has undertaken largely have been for non-equity investments, almost the reverse of the bullish sentiment before Oct. 19. An exception to the new bearishness is the post-crash upswing in interest in small-capitalization stock managers.

Based on its own activity, SEI Corp., Wayne, Pa., reports it was engaged for 45 searches in the six months ended April 30, down 30% from its 64 search engagements in the six months ended Sept. 30.

Of its post-crash searches, only 36%, or 16 searches, were for domestic equity managers (excluding small-cap stock managers).

By contrast, in the pre-crash period, 73%, or 47 searches, were for domestic equity managers (again, excluding small-cap managers).

Broader data compiled by SEI from published accounts in *Pensions & Investment Age* and elsewhere of non-SEI searches during the same periods confirm its own trend in search activity.

That data of non-SEI engagements show the number of searches fell 40% to 187 in the six post-crash months, from 309 in the pre-crash period. Of these post-crash searches, only 31%, or 58 searches, were for domestic equity managers (excluding small-cap searches), in contrast to 47%, or 145 searches, in the six pre-crash months.

"People are more conservative after the crash and are looking for less volatile investments, particularly, real estate and fixed income," said Dave O'Donovan, SEI vice president in Chicago, commenting on the survey.

In addition, he said, "They are looking at international (investments) for diversification."

SEI's Dave O'Donovan says funds are seeking less volatile investments after the crash.

The international move "doesn't fit as neatly into the conservative notion," he added. "But international markets are not as closely correlated with U.S. markets," underscoring their role in diversification, he added.

"Everyone is concerned about being vulnerable like they were in October," Mr. O'Donovan said.

Also, he noted many sponsors have undertaken asset allocation studies since the crash, putting off any searches. Comparison data on this activity weren't compiled.

In the period after the crash, SEI was engaged for five small-cap, one international fixed-income and nine real-estate searches, together comprising 33% of its consulting searches. By contrast, it was engaged in no searches for any of the three asset classes in the six months before the crash.

SEI's post-crash domestic fixed-income searches also were up, although only in relative terms considering all types of searches were down. SEI had 11 domestic fixed-income searches, representing 24% of all SEI search activity. In the pre-crash period, they totaled 12, or only 19% of its searches.

SEI's international equity searches fell in relative terms to three, or 7%, of total activity, in the post-crash months, compared with five, or 8%, in the pre-crash period.

The broader non-SEI search activity, however, showed international equity searches were up in relative terms, to 36 searches, or 19% of all searches, compared with 45 searches, or 14.5%.

SEI reported its search activity for October separately. In that month, it was engaged in seven searches — three for domestic equity, one for international equity and three for real estate.

The non-SEI data show a decidedly domestic fixed-income tilt. Of the 30 non-SEI searches in October, 12 were for domestic fixed income, 14 for domestic equity, three for international equity and one for real estate.

Other data for the non-SEI searches in the post-crash period, show that nine, or 5%, were for small-cap stocks; 28, or 15%, for real estate; 46, or 25%, for domestic fixed income; and 10, or 5%, for international fixed income.

By contrast, in the six pre-crash months, the non-SEI searches data show that five searches, or 1.6%, were for small-cap; 36, or 11.7%, were for real estate; 73, or 23.6%, were for domestic fixed income; and five, or 1.6%, for international fixed income. ■

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# Performance

*Continued from page 13*

possible effects of performance fees on profitability and annual incentive pay? One answer might be the strengthening of multiyear "consistency" measures in plan designs. In order to receive top rewards, successful fund managers may more often be required to produce top-quartile investment results over rolling two- or three-year periods.

One year's results might affect the target incentive award in the next year, or alter the payout of a prior year's award that had been deferred for the purpose of employee retention. This approach would smooth out the major variances in incentive pay, avoiding both windfalls and shortfalls.

Another approach might be to accept a much greater volatility in individual awards, regardless of firm performance. Thus, a top-performing portfolio manager would receive top pay even if the firm suffers a down year. Conversely, the annual bonus of a poorly performing manager would not be cushioned by firm profitability even in an overall up year.

This sink-or-swim mentality might become pervasive if firms cannot absorb the effects of significantly reduced revenue caused by poor portfolio results directly attributable to economic events or individual performance.

To understand why investment management firms are adjusting their incentive pay systems, it's helpful to understand the common shortcomings of current incentive compensation programs for professional portfolio managers.

One shortcoming is the failure to select and use appropriate criteria for performance measurement. Selecting the appropriate comparative universe or established market index is critical to the fairness and effectiveness of any pay for performance system.

The initial selection should not be a static one. Management firms and pension sponsors must reassess the appropriateness of their competitive "yardsticks" on a regular basis.

Periodic reviews of criteria ensure that changing economic conditions and market factors, as well as competitors' strategies, are factored into the incentive pay equation. Many firms find a combination of criteria is the fairest and most accurate way to assess performance.

A second problem area is uncertainty in determining how much to pay for the desired level of performance. Most firms strive to pay their portfolio professionals at competitive levels, or even aggressively when superior levels of investment performance have been achieved.

Common sense, as well as most existing annual incentive formulas, dictates high payouts be linked to high comparative performance and that low or no payouts will result from poor comparative performance. In an era of highly volatile firm revenue and earnings, beating the competition and market indexes in the relative sense might not be enough to justify aggressive compensation.

A distinct weakness of some plans is the failure to set appropriate targets for annual incentive pay. In many cases, the key to deriving real incentive (motivational) value from a compensation scheme is the firm's ability to communicate a potential target level of award to successful portfolio managers.

It is this simple quid pro quo that represents the essential element of annual incentive pay plans for investment professionals.

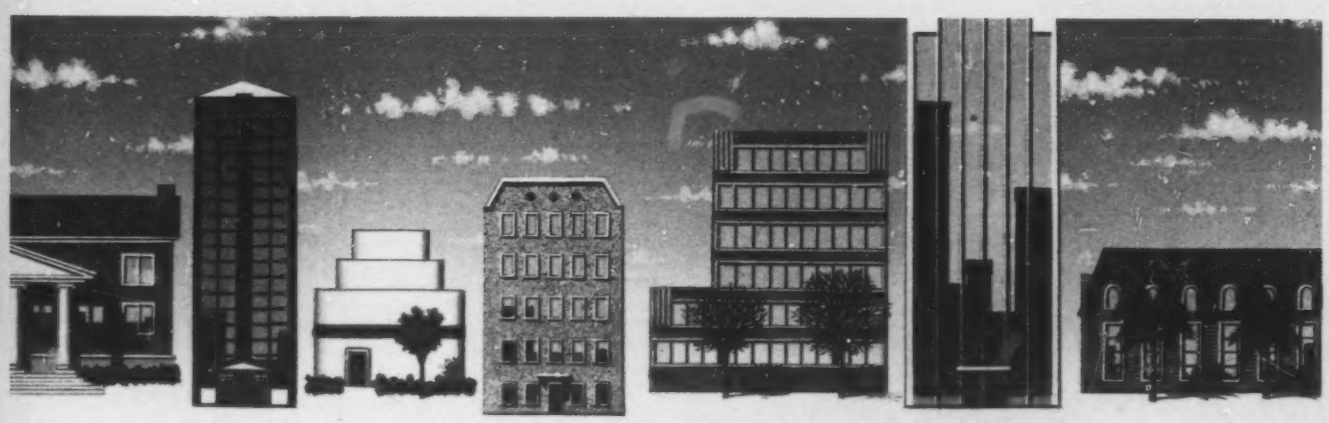
The top players need to know the rules, and what they stand to win or lose. This is what promotes energetic effort and gives added impetus to those who fulfill the responsibilities of institutional portfolio manager or corporate investment professional.

Finally, incentive pay programs often fail to support the investment and organizational strategy of the firm, both short and long term.

The internal structure and dynamics of the compensation arrangements must be consistent with the kind of individual and group behavior desired.

A plan should be designed to reinforce behavior that promotes the objectives of the firm (e.g., team play vs. star system) and to discourage non-productive behavior.

The incentive compensation issue is evolving rapidly and will be the subject of much further discussion. Firms should anticipate and address the potential effects (both positive and negative) of performance-based fees on their ability and willingness to pay, before financial circumstances limit their compensation flexibility. ■

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# Management firm spun off by Kemper

CHICAGO — Kemper Financial Services Inc. has spun off its investment management division into Kemper Asset Management Co. in order to position itself for expansion and acquisition.

The new subsidiary of the financial services company, widely known for its mutual fund and life insurance units, also will give its investment advisory services a higher public profile and enable the company to retain talented people and attract others, according to Len Spalding Jr., senior managing director of the new subsidiary.

Kemper Financial Services manages about $41 billion. Kemper Asset Management is managing the $3 billion in tax-exempt assets previously managed by Kemper Financial. Kemper Asset has about 50 clients, primarily pension funds.

Kemper's tax-exempt total is down about $1 billion from last year, because of the loss of one client, which Kemper officials would not name.

"The loss of one large client made Kemper realize that this thing won't swim by itself," Mr. Spalding said.

"We need to become known as our own entity, rather than as a part of Kemper. We also need to make people inside the Kemper organization aware of us."

"We're trying to build a base for substantial growth over the next several years," he said. "The company is interested in making it much bigger. We want to acquire other companies. We want to grow by acquisition and by managing money."

Kemper hopes to acquire companies for which it can provide strong marketing and sales abilities and through which it can develop hybrid investment products tailored to the needs of the client.

Mr. Spalding said Kemper might acquire a West Coast firm to support its clients there. ■